

REBUTTAL TESTIMONY
OF
JANIS FREETLY
FINANCIAL ANALYST
FINANCE DEPARTMENT
FINANCIAL ANALYSIS DIVISION
ILLINOIS COMMERCE COMMISSION

AMERITECH ILLINOIS
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1

Introduction

2 **Q. Please state your name and business address.**

3 A. My name is Janis Freetly. My business address is 527 East Capitol Avenue,
4 Springfield, Illinois 62701.

5 **Q. Are you the same Janis Freetly that prepared and submitted direct**
6 **testimony on behalf of the Illinois Commerce Commission**
7 **(“Commission”) in this matter?**

8 A. Yes, I am.

9 **Q. What is the purpose of your rebuttal testimony?**

10 A. The purpose of my rebuttal testimony is to respond to a portion of the direct
11 testimony of William Dunkel, GCI Exhibit 8.0, and the rebuttal testimony of
12 William E. Avera, AI Exhibit 8.1. Specifically, I will further explain the
13 relationship between a company's capital structure and the cost of common
14 equity and why book value capital structure should be used in determining
15 the proper rate of return for Ameritech Illinois (AI) in the context of traditional
16 rate setting procedures. In addition, I will present my recommendation of the
17 overall cost of capital of AI for LRSIC purposes.

Response to GCI witness Dunkel

18

19 **Q. On page 56 of his direct testimony, Mr. Dunkel states that the mid-**
20 **range of the Staff common equity range would have been higher than**
21 **the cost of equity that AI is requesting.¹ Please comment.**

22 A. Mr. Dunkel is correct, the cost of equity midpoint estimate of 13.10% that I
23 recommend in my direct testimony is higher than that requested by AI.²
24 However, one should not compare cost of equity estimates without reference
25 to capital structure. The effect of the interaction of the capital structure and
26 the cost of equity is manifested in the overall cost of capital, which represents
27 the weighted average cost of each capital component.

28 **Q. How does a company's capital structure affect the cost of equity and**
29 **overall cost of capital?**

30 A company's overall cost of capital is a function of both the costs and the relative
31 amounts of its various sources of financing. If a company increases the
32 proportion of equity in its capital structure, then its financial risk will decline.
33 The decrease in financial risk will reduce the cost of each capital component,
34 including common equity. However, since equity is the most costly
35 component of the capital structure, an excessive proportion of common
36 equity will result in an unnecessarily high overall cost of capital.

37 Since a company's debt costs are tax deductible, increasing the proportion of
38 debt in the capital structure can lower its overall cost of capital. However,
39 raising the proportion of debt in the capital structure increases financial risk.
40 The cost of each capital component, including common equity, will rise as the
41 financial risk of the company increases. Therefore, a capital structure too
42 heavily weighted with either debt or equity can produce an unreasonably high
43 overall cost of capital.

44 **Q. How does your estimate of AI's overall cost of capital compare to AI's**
45 **estimate?**

46 A. My estimate of AI's overall cost of capital (10.52%) is lower than AI's
47 estimate (10.90%).³ AI's lower cost of equity estimate, when combined with
48 its unreasonably high common equity ratio, inflates its weighted cost of equity
49 and its overall cost of capital estimate.

¹ GCI Exhibit 8.0, Direct Testimony of William Dunkel, p. 56, footnote 58.

² Staff Exhibit 11.0, Direct Testimony of Janis Freetly, Schedule 11.11; AI Exhibit 6.0, Direct Testimony of Roger G. Ibbotson, Schedule 13.

³ Ibid.

Response to AI witness Avera

50

51 **Q. Please respond to Dr. Avera's comments regarding use of a market**
52 **value capital structure in determining AI's rate of return in this**
53 **proceeding.⁴**

54 A. Without commenting on the merits of Dr. Avera's arguments that in a
55 competitive economy market values are the standard for measuring capital
56 structure, I will explain further why use of AI's book value capital structure is
57 appropriate for use in this proceeding. The purpose of my direct testimony
58 was to present my analysis of AI's weighted average cost of capital in the
59 event that the Commission orders rate re-initialization on the basis of
60 traditional rate base/ rate of return regulation. For the reasons set forth in my
61 direct testimony, book value capital structure is appropriate for that purpose.⁵
62 Dr. Avera seems to agree that under the traditional rate of return regulatory
63 framework, book-value capital structure is appropriate.⁶ Hence, in the event
64 that the Commission decides to re-initialize AI's rates for non-competitive
65 services based on rate base/ rate of return assumptions, the book value
66 capital structure for the year ended December 31, 1999 that I presented on

⁴ AI Exhibit 8.1, Rebuttal Testimony of William E. Avera, Ph. D., CFA, pp. 9-14.

⁵ Staff Exhibit 11.0, Direct Testimony of Janis Freetly, pp. 5-6.

⁶ AI Exhibit 8.1, Rebuttal Testimony of William E. Avera, Ph. D., CFA, p. 9.

67 Schedule 11.01 of my direct testimony is appropriate for determining AI's
68 overall cost of capital.⁷

69 **LRSIC Cost of Capital**

70 **Q. What overall cost of capital do you recommend for long-run service**
71 **incremental cost (LRSIC) purposes?**

72 A. My recommended overall cost of capital of AI for LRSIC purposes is 10.75%,
73 as shown in Schedule 25.01.

74 **Q. What is your estimate of AI's marginal cost of short-term debt?**

75 A. My estimate of AI's marginal cost of short-term debt is 6.61%. This cost is
76 the same as my cost of short-term debt estimate for determining the overall
77 cost of capital for revenue requirement purposes, as explained in my direct
78 testimony.⁸

79 **Q. How did you determine the marginal cost of long-term debt?**

80 A. AI's current credit rating from Standard & Poor's is AA-.⁹ As of September
81 6, 2000, newly issued thirty-year Aa rated utility debt had an average cost of
82 7.96%.¹⁰ I used the cost from September 6, 2000 to ensure consistency with

⁷ Staff Exhibit 11.0, Direct Testimony of Janis Freetly, Schedule 11.01.

⁸ Staff Exhibit 11.0, Direct Testimony of Janis Freetly, pp. 8-9.

⁹ Standard & Poor's Ratings Direct, www.ratingsdirect.com/cgi-bin/gx.cgi/AppLogic+SimpleSearch, January 8, 2001.

¹⁰ Moody's - Economic Commentary - Moody's Indices and Yield Averages, www.moody's.com/moodys/cust/ecocomm/averages_ecocom.asp, September 15, 2000.

83 my 13.10% cost of equity estimate that was derived as explained in my
84 direct testimony, Staff Exhibit 11.0. Hence, my estimate of AI's marginal cost
85 of long-term debt is 7.96% as shown on Schedule 25.01.

86 **Q. Why did you not utilize the 11.97% cost of equity authorized by the**
87 **Commission in Docket 92-0448/93-0239 (Consol.)?**

88 A. I did not utilize 11.97% as AI's cost of equity because I performed an
89 analysis to determine the current cost of equity for AI as explained in detail in
90 my direct testimony. Since AI's cost of equity, in my judgement, is 13.10%, I
91 am utilizing the 13.10% cost of equity in determining the proper forward-
92 looking cost of capital to be used for LRSIC purposes.

93 **Q. How did you arrive at the capital structure shown on Schedule 25.01?**

94 A. Ideally, in determining a forward-looking cost of capital, a company's target
95 capital structure should be used. AI states that its target capital structure
96 consists of 75% equity and 25% debt.¹¹ However, I believe that capital
97 structure to be overly costly. I calculated the pre-tax interest coverage ratio
98 using AI's proposed LRSIC cost of capital, as shown on Schedule 25.01,
99 which produced an implied pre-tax interest coverage ratio of 10.45x. I then
100 compared this ratio with the benchmarks for telecommunications companies

¹¹ AI Exhibit 1.1, Supplemental Direct Testimony of David H. Gebhardt, p. 111; AI Exhibit 6.0, Direct Testimony of Roger G. Ibbotson, pp. 10 and 38.

published by Standard & Poor's (S&P).¹² The implied pre-tax interest coverage ratio of 10.45x greatly exceeds the S&P benchmark for AA rated telecommunications companies of over 4.5x.

Next, I calculated the implied pre-tax interest coverage ratio using a capital structure consisting of 60% equity and 40% debt, and the component costs shown on Schedule 25.01. The resulting implied pre-tax interest coverage ratio of 5.51x still exceeds the S&P benchmark for AA rated telecommunications companies of over 4.5x. Further, the S&P benchmark for A rated telecommunications companies is 3.5x through 5.5x. The 5.51x implied pre tax interest coverage ratio is at the top end of that range, which is consistent with AI's AA- credit rating. This suggests that the capital structure and costs that I am recommending are sufficient for AI to maintain its current strength as an AA- rated telecommunications company at a lower cost than the target capital structure proposed by AI.

Q. Do you agree that a company's market value capital structure should be used for LRSIC purposes?

A. When determining a forward-looking marginal capital structure, the issue of market value versus book value is irrelevant. The appropriate capital structure for LRSIC purposes would reflect the proportion of capital that AI would raise on the margin to finance new investment. Since new capital is

¹² Standard & Poor's Ratings Direct: - Financial Medians: Telecommunications Companies,

121 recorded on a company's books at market value, the book value of new
122 capital equals its market value. As a result, the market value of AI's marginal
123 capital structure would have proportions identical to its marginal book value
124 capital structure.

125 **Q. Does this conclude your rebuttal testimony?**

126 A. Yes, it does.

June 16, 1999.

Ameritech Illinois

LRSIC Overall Cost of Capital

AI Proposal

<u>Component</u>	<u>Percent of Total Capital</u>	<u>Cost</u>	<u>Weighted Cost</u>	<u>Weighted Pre-tax Cost</u>
Debt	25.00%	6.30%	1.58%	1.58%
Common Equity	<u>75.00%</u>	11.97%	<u>8.98%</u>	<u>14.88%</u> ¹
	100.00%		10.56%	16.46%

Implied Pre-tax Interest Coverage Ratio: 10.45x²

Staff Proposal

<u>Component</u>	<u>Total Capital</u>	<u>Cost</u>	<u>Cost</u>	<u>Pre-tax Cost</u>
Short term Debt	22.00%	6.61%	1.46%	1.46%
Long-term Debt	18.00%	7.96%	1.43%	1.43%
Common Equity	<u>60.00%</u>	13.10%	<u>7.86%</u>	<u>13.03%</u> ¹
	100.00%		10.75%	15.92%

Implied Pre-tax Interest Coverage Ratio: 5.51x²

¹ Weighted pre-tax cost of equity = weighted cost of equity * gross revenue conversion factor (Staff Exhibit 5.0, Schedule 5.05, p. 1 of 2)

² Implied Pre-tax Interest Coverage Ratio = weighted pre-tax cost of capital / weighted cost of total debt